



[4830-01-p]

## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9638]

RIN 1545-BK03

Application of the Segregation Rules to Small Shareholders

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 382 of the Internal Revenue Code (Code). These regulations provide guidance regarding the application of the segregation rules to public groups of shareholders in determining owner shifts and ownership changes under section 382 of the Code. These regulations affect corporations.

DATES: Effective date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability date: For dates of applicability, see §1.382-3(j)(17).

FOR FURTHER INFORMATION CONTACT: Stephen R. Cleary, (202) 622-7750, or Marie C. Milnes-Vasquez, (202) 622-7530 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

### **Background**

Section 382 imposes a limitation on a corporation's use of net operating loss carryovers and certain other attributes following a change in ownership of the

corporation (loss corporation). A loss corporation has an ownership change if the percentage of stock of a loss corporation that is owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation owned by such shareholders at any time during the testing period (generally, a three-year period). Pursuant to section 382(g)(4)(A), individual shareholders who own less than five percent of a loss corporation are aggregated and treated as a single 5-percent shareholder (a public group).

The regulations extend the public group concept to situations in which a loss corporation is owned by one or more entities, as defined in §1.382-3(a) (generally, partnerships, corporations, estates, and trusts). If an entity directly or indirectly owns five percent or more of the loss corporation, that entity has its own public group if its owners who are not 5-percent shareholders own, in the aggregate, five percent or more of the loss corporation. An entity that owns a five-percent or more direct interest in a loss corporation at any time during a testing period is a “first tier entity,” and a “higher-tier entity” is any entity owning a five-percent or more direct interest in a first tier entity or any other higher tier entity at any time during a testing period. (Such entities are referred to as 5-Percent Entities in this preamble.)

The application of the segregation rules results in the creation of a new public group in addition to the one (or more) that existed previously. That new group is treated as a new 5-percent shareholder that increases its ownership interest in the loss corporation.

The segregation rules apply to transfers of loss corporation stock by an individual 5-percent shareholder to public shareholders and a 5-Percent Entity's transfer of loss corporation stock to public shareholders. In addition, the current segregation rules, subject to the cash issuance and small issuance exceptions (described in this preamble), treat issuances of stock under section 1032, redemptions, and redemption-like transactions as segregation events.

Generally, the small issuance exception exempts the total amount of stock issued during a taxable year to the extent it does not exceed 10 percent of the total value of the corporation's outstanding stock at the beginning of the taxable year or 10 percent of the class of stock issued and outstanding at the beginning of the taxable year (the 10-percent limitation). However, the small issuance exception does not apply to any issuance of stock that, by itself, exceeds the 10-percent limitation. If stock is issued solely for cash, the cash issuance exception exempts a percentage of the total stock issued equal to 50 percent of the aggregate percentage ownership interest of the public groups of the corporation immediately before the issuance. If the small issuance exception excludes only a portion of a stock issuance, the cash issuance exception may apply to the portion not excluded under the small issuance exception.

Notice 2010-49, 2010-27 IRB. 10, invited public comment relating to possible modifications to the regulations under section 382 regarding the treatment of shareholders who are not 5-percent shareholders (Small Shareholders). See §601.601(d)(2)(ii)(b). On November 23, 2011, the IRS and the Treasury Department published a notice of proposed rulemaking in the **Federal Register** (REG-149625-10, 2012-2 IRB 279;76 FR 72362-01) containing proposed regulations (proposed

regulations) that, if finalized, would provide relief in certain cases from the segregation rules of the current regulations under section 382.

### **Summary of Proposed Regulations**

The proposed regulations provide exceptions, in addition to those in the current regulations, that would exempt from the segregation rules certain transactions involving the stock of loss corporations and 5-Percent Entities. The preamble to the proposed regulations explains that these additional exceptions are intended to reduce tax administration and compliance burdens with respect to transactions that do not bear indicia of loss trafficking, and thus do not implicate the policies underlying section 382.

#### **A. Secondary Transfer Exception**

The proposed regulations generally would render the segregation rules inoperative with respect to transfers of loss corporation stock to Small Shareholders by 5-Percent Entities or individuals who are 5-percent shareholders. In these cases, the stock transferred will be treated as being acquired proportionately by the public groups existing at the time of the transfer. This rule also applies to transfers of ownership interests in 5-Percent Entities to public owners and to 5-percent owners who are not 5-percent shareholders.

#### **B. Small Redemption Exception**

The proposed regulations provide an exception that would exempt small redemptions of the stock of a loss corporation from the segregation rules (small redemption exception) that is based upon the 10-percent limitation of the small issuance exception in the current regulations. The small redemption exception would annually exempt from the segregation rules, at the loss corporation's option, either redemptions

of loss corporation stock equal to 10 percent of the total value of the loss corporation's stock at the beginning of the taxable year, or redemptions of loss corporation stock of up to 10 percent of the number of shares of the redeemed class of loss corporation stock outstanding at the beginning of the taxable year. Pursuant to this exception, each public group existing immediately before the redemption would be treated as redeeming its proportionate share of exempted stock.

C. General Exception to Segregation Rules for 5-Percent Entities

Under the proposed regulations, the segregation rules would not apply to certain transactions involving a 5-Percent Entity (general exception). Under the general exception, the segregation rules would not apply if, on the date of the transaction at issue, (i) the 5-Percent Entity owns 10 percent or less (by value) of all the outstanding stock of the loss corporation (ownership limitation), and (ii) the direct or indirect investment in the stock of the loss corporation does not exceed 25 percent of the 5-Percent Entity's gross assets (asset threshold). For purposes of the asset threshold, the 5-Percent Entity's cash and cash items within the meaning of section 382(h)(3)(B)(ii) would not be taken into account.

The preamble to the proposed regulations describes the purpose of the general exception:

The IRS and the Treasury Department believe that the proposal strikes an appropriate balance between reducing complexity and safeguarding section 382 policies. The proposal will enable loss corporations to disregard indirect changes in its ownership that may, under the current regulations, require burdensome information gathering and may unnecessarily impede the loss corporation's ability to reorganize its affairs. At the same time, however, the proposal imposes criteria that protect the government's interests. The asset threshold makes it unlikely that the loss corporation's attributes motivate transactions in the equity of 5-Percent Entities. Additionally, like the small issuance exception and the relief for redemptions that appears elsewhere in this proposal, the ownership limitation

makes it unlikely that transactions among Small Shareholders one or more tiers removed from the loss corporation implicate loss trafficking concerns. \* \* \*

## **Summary of Comments and Explanation of Provisions**

Comments were received in response to the proposed regulations. A public hearing was not requested, and none was held. The comments generally supported the provisions of the proposed regulations, but requested a number of revisions. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. In general, the final regulations follow the approach of the proposed regulations, with some revisions. The more significant comments and revisions are discussed in this section.

### **A. Secondary Transfer Segregation Rule**

The proposed regulations contain a clarification of the application of §1.382-2T(j)(3) of the current regulations (secondary transfer segregation rule). Under the secondary transfer segregation rule, in general, the segregation rules apply to secondary public transfers of loss corporation stock (that is, transfers of loss corporation stock from 5-percent shareholders or first tier entities to public shareholders). Section 1.382-2T(j)(3) of the current regulations further provides that the “principles” of the foregoing rule apply to “transactions in which an ownership interest in a higher tier entity that owns five percent or more of the loss corporation (determined without regard to [§1.382-2T(h)(i)(A)]) or a first tier entity is transferred to a public owner or a 5-percent owner who is not a 5-percent shareholder.” The IRS and the Treasury Department became aware that it is unclear whether the secondary transfer segregation rule applies to transfers of higher tier entity stock by a transferor that does not indirectly own five percent or more in the relevant loss corporation. New §1.382-3(i) of the proposed

regulations would clarify that the secondary transfer segregation rule applies to a transfer of higher tier entity stock only if the seller indirectly owns five percent or more of the loss corporation.

After further considering the interaction between §1.382-3(i) and the secondary transfer exception of §1.382-3(j)(13) of the proposed regulations, the IRS and the Treasury Department have concluded that it is not necessary to retain a stand-alone rule clarifying the operation of the secondary transfer segregation rule in the final regulations because the secondary transfer exception eliminates all of the segregation rules of §1.382-2T(j)(3) with respect to all secondary transfers occurring after the regulations are published as final regulations. However, the substance of the clarification contained in §1.382-3(i) of the proposed regulations has been incorporated into the final version of the secondary transfer exception of §1.382-3(j)(13) to confirm that the segregation rules, and therefore the secondary transfer exception, apply to secondary transfers of stock of a loss corporation or 5-Percent Entity only if the transferor indirectly owns 5-percent of the loss corporation. In addition, the IRS will not challenge application of the clarification contained in §1.382-3(i) of the proposed regulations to transfers occurring on dates before **[INSERT DATE THAT THESE REGULATIONS ARE PUBLISHED IN THE FEDERAL REGISTER]**.

B. Small Redemption Exception

Two commenters requested that the small redemption exception be expanded to exempt redemptions of up to 25 percent of the total value of stock or number of shares of a class of stock. The commenters argued that, because redemptions do not inject new capital into a loss corporation but rather contract the corporation's capital, the

regulations should allow a more generous exemption from the segregation rules for redemptions than for stock issuances.

After consideration of the comments, the IRS and the Treasury Department have determined that the ceiling on the small redemption exception should remain at 10 percent. As discussed in greater detail in the preamble to the proposed regulations, the provisions of the proposed regulations were intended to reduce tax administration and compliance burdens with respect to transactions that do not implicate the policies of section 382. To that end, occasional redemptions of stock, which, in the aggregate, represent a small percentage of the issuer's equity, are unlikely to be used as a device to shift the ownership of a loss corporation. Accordingly, relief from application of the segregation rules is appropriate. Raising the ceiling on the size of redemptions to which the small redemption exception applies to 25 percent could be used to effectuate significant shifts in ownership contrary to the policies of section 382.

C. Application of Small Issuance and Small Redemption Exceptions to 5-Percent Entities

Commenters requested that the small redemption exception be extended to exempt redemptions of the stock of 5-Percent Entities from the segregation rules. These commenters noted that the secondary transfer exception provided in the proposed regulations exempts certain transfers of the stock of 5-Percent Entities from the segregation rules, as does the small issuance exception in the current regulations. Additionally, one commenter noted that if the small redemption exception were extended to redemptions by 5-Percent Entities, guidance should be provided to supply the baseline against which to measure the 10-percent limitation of the small redemption



exception in such cases. Specifically, the commenter asked for clarification regarding whether the limitation would be calculated by reference to the stock of the redeeming corporation, or, alternatively, by reference to the stock of the loss corporation.

In response to these comments, the final regulations extend the small redemption exception to exempt redemptions of the stock of 5-Percent Entities from the segregation rules. Further, the IRS and the Treasury Department have concluded that the 10-percent limitation of the small redemption exception should be measured by reference to the stock of the entity engaging in the redemption. Calculating the 10-percent limitation by reference to the stock of the redeeming entity will ensure that this exception, consistent with its intended purpose, applies only to redemptions that are “small.” For example, assume that a first tier entity, the stock of which has a value of \$150, owns an 8 percent stake in a loss corporation, the stock of which has an aggregate value of \$750. If the 10-percent limitation were applied by reference to the value of the loss corporation’s stock, then the first tier entity would be permitted to redeem an amount of stock equal to 50 percent of its pre-existing stock (that is, 10 percent of \$750 ( $\$75/\$150$ )) without application of the segregation rules. This result is inappropriate. Accordingly, these final regulations provide that the 10-percent limitation of the small redemption exception applies by reference to the value of the entity (or to the classes of stock of the entity, as the case may be) that is engaging in the redemption.

In the preamble to the proposed regulations, the IRS and the Treasury Department requested comments as to whether further refinement of the small issuance exception in the current regulations might be warranted in the context of any potential

expansion of the additional exceptions proposed therein. As discussed, these final regulations expand the small redemption exception to apply to redemptions of the stock of 5-Percent Entities, and provide that the stock of the 5-Percent Entity engaging in the redemption is the appropriate baseline for computing the 10-percent limitation for the small redemption exception in such cases. In comments received in response to the proposed regulations, one commenter noted that the small issuance exception in the current regulations applies to issuances of stock of 5-Percent Entities and contains a parallel 10-percent limitation on the amount of stock issued that qualifies for this exception. Further, the commenter pointed out that the same question of the appropriate baseline for applying the 10-percent limitation exists with regard to the small issuance redemption. The commenter requested that these final regulations supply clarification with regard to the appropriate baseline for applying the small issuance exception to issuances of stock of 5-Percent Entities.

After consideration of this comment, the IRS and the Treasury Department have determined that the same policy considerations discussed with regard to the application of the small redemption exception to 5-Percent Entities exist with regard to the application of the small issuance exception to 5-Percent Entities. Thus, these final regulations provide that the 10-percent limitation of the small issuance exception in the current regulations is calculated by reference to the same baseline used for the small redemption exception. Accordingly, these final regulations provide that the 10-percent limitation for the application of the small issuance exception to issuances of stock by a 5-Percent Entity is calculated by reference to the value of the stock of the issuing entity (or to the classes of stock of that entity, as the case may be).

D. General Exception to Segregation Rules for 5-Percent Entities

Some commenters proposed increasing the ownership limitation for the general exception from 10 percent to a higher percentage (between 15 and 30 percent) to increase the number of 5-Percent Entities that would qualify for the general exception to the segregation rules. After consideration of these comments, the IRS and the Treasury Department have concluded that it is appropriate for the ownership limitation of the general exception to remain at 10 percent in the final regulations. The IRS and the Treasury Department believe that maintaining the ownership limitation at 10 percent represents an appropriate balance between reducing administrative and compliance burdens while protecting against transactions that may raise loss trafficking concerns. Accordingly, the final regulations retain the 10-percent ownership limitation.

Several commenters expressed concern that loss corporations would not be able to verify that a 5-Percent Entity's ownership of loss corporation stock does not exceed the 25-percent asset threshold. Although the loss corporation could request such information from the 5-Percent Entity, there is no requirement that the 5-Percent Entity provide it (and it may be legally obliged not to provide such information). In response to that concern, some commenters suggested that a loss corporation should be able to apply the general exception if it determines in good faith that it has satisfied a duty of inquiry with regard to satisfaction of the asset threshold by a particular 5-Percent Entity. In addition, questions were raised whether the asset threshold could be replaced with an anti-avoidance rule designed to frustrate abuses that could arise in the absence of the asset threshold.

The preamble to the proposed regulations explains that the asset threshold was

created to ensure that the segregation rules would continue to apply to transactions in the stock of 5-Percent Entities that were motivated by attempts to exploit the attributes of the loss corporation. In effect, the IRS and the Treasury Department imposed the combination of the ownership limitation and the asset threshold as the equivalent of an anti-avoidance rule, though formulated as an objective test. However, the comments received indicate that the asset threshold, as presented in the proposed regulations, would prevent the general exception to the segregation rules from achieving the goal of reducing complexity while safeguarding section 382 policies.

After consideration of the comments, the IRS and the Treasury Department have decided to replace the asset threshold test with an anti-avoidance rule. The anti-avoidance rule provides that the general exception to the segregation rules does not apply to a transaction involving an ownership interest in a 5-Percent Entity if the loss corporation, directly or through one or more persons, has participated in planning or structuring the transaction with a view to avoid the application of the segregation rules. This anti-avoidance rule will more directly address the tax avoidance concerns underlying the asset threshold included in the proposed regulations while reducing tax compliance burdens with regard to transactions with low tax avoidance potential. The existence of the 10-percent ownership limitation will ensure that the general exception applies only with regard to transactions involving holders who have relatively small ownership interests in the loss corporation and, therefore, are unlikely to be vehicles for avoidance planning. In addition, this anti-avoidance rule would not be violated in the common situation in which the loss corporation seeks and obtains (or seeks and cannot obtain) information about a proposed transaction that would change the ownership of a

5-Percent Entity, but the loss corporation does not take part in planning or structuring the transaction.

E. Correction of General Exception Example

Commenters pointed out a technical error in one general exception example (Example 11 in §1.382-3(j)(16) of the proposed regulations) and requested its correction. The commenters pointed out that the example mistakenly treats an entity as a first tier entity although its only interest in the loss corporation is preferred stock meeting the requirements of section 1504(a)(4). The IRS and the Treasury Department agree that the example is technically flawed because section 1504(a)(4) stock is disregarded for purposes of determining ownership shifts. We note that Example 11 assumes a modified version of the facts of Example 10. Therefore, in order to correct the illustration of the general exception by Example 11, these final regulations contain modifications to Examples 10 and 11, which provide that, in addition to the preferred stock, the shareholder entity owns sufficient common stock at the outset of the example to be tracked as a first tier entity.

F. Effective Dates

The proposed regulations provide that the proposed exceptions to the segregation rules would apply to testing dates occurring on or after the date the regulations are published as final regulations in the **Federal Register** (the Publication Date). Commenters have requested that the regulations should allow taxpayers to apply the proposed regulations retroactively. One commenter suggested that taxpayers should be permitted to apply the proposed regulations retroactively, regardless of whether such application would reverse a prior ownership change either in a closed or

an open year, provided that taxpayers were required to revise carryforward schedules consistently with any such change. (For example, if application of the proposed regulations in a closed year would reverse an ownership change, the taxpayer would be required to adjust its carryforward schedule to the extent net operating losses would have been absorbed in one or more closed years.) This commenter pointed to the small issuance and cash issuance exceptions as provisions with a similar effective date. Another commenter pointed out that the proposed effective date would create inconsistencies in the treatment of Small Shareholders on testing dates within a single testing period when the Publication Date occurs during the testing period. This comment proposed three alternatives that would allow a loss corporation to consistently apply the new rules to (a) testing dates on or after the Publication Date; (b) all testing dates within a testing period that includes the Publication Date; or (c) testing periods for which all of the testing dates occur after the Publication Date.

After consideration of the comments, the final regulations do not permit taxpayers to apply the final regulations to a testing date before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]** if the application of the final regulations would result in an ownership change that did not occur, or would reverse an ownership change that did occur, on a date before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]** under the regulations then in effect. The IRS and the Treasury Department believe that, in general, ownership change determinations from prior periods should remain fixed, and that the interests of tax administration are not served by permitting taxpayers to choose whether it is more advantageous to retain an ownership change result from a prior

period or to reverse that result through the application of new regulations. For this reason, the final regulations retain the general effective date of the proposed regulations. The final regulations do, however, permit taxpayers to apply the provisions of the final regulations in their entirety to all testing dates that are included in a testing period beginning before and ending on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, subject to the limitations that (1) the final regulations may not be applied to any date on or before the date of any ownership change that occurred on a date before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]** under the regulations in effect before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, and (2) they may not be applied if their application would result in an ownership change occurring on a date before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]** that did not occur under the regulations in effect before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

For example, assume that a loss corporation experienced an ownership change on October 1, 2012, and the current testing period began on October 2, 2012. Following the publication of the final regulations on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, the loss corporation wishes to permissively apply the regulations to all dates of its testing period that begins before and ends on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. The regulations may be permissively applied beginning on October 2, 2012, but only if such application does not result in an ownership change

occurring on a date before [INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER] that did not occur under the regulations in effect during the period before [INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]. Because the final regulations may not be applied to any date on or before the date of any ownership change that occurred before [INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER] under the regulations in effect before that date, the final regulations may not be permissively applied to October 1, 2012, or any earlier date.

G. Revisions to the Small Issuance and Cash Issuance Exceptions

The preamble to the proposed regulations requested comments as to whether further refinement of either or both of the small issuance or cash issuance exceptions might be warranted in the context of any potential expansion of the exceptions contained in the proposed regulations. After consideration of the comments received, the IRS and the Treasury Department believe that no changes to the small issuance or cash issuance exceptions should be made, other than the clarification regarding the calculation of the 10-percent limitation for the small issuance exception.

Comments generally requested increasing the 10-percent limitation of the small issuance exception. Because the final regulations do not increase the 10-percent limitation for the small redemption exception, the IRS and the Treasury Department have determined that the 10-percent limitation of the small issuance exception should also not be increased in order to maintain parity with the small redemption exception. Furthermore, as discussed in the preamble to the proposed regulations, the IRS and the Treasury Department remain concerned that transactions infusing new capital into a



loss corporation implicate section 382 policies because the capital infusion can accelerate the use of tax attributes. This is the case even if the new investors are Small Shareholders, especially in light of the dilutive effect of the cash issuance exception on owner shifts attributable to capital-raising transactions. Accordingly, the final regulations do not expand the 10-percent limitation of the small issuance exception.

Comments also suggested that the cash issuance exception should apply to issuances of stock for non-cash property, including debt. One commenter requested that the IRS and the Treasury Department consider expanding the definition of a “cash issuance” to include loss corporation stock issued in connection with the conversion of a convertible debt instrument issued by the loss corporation in exchange for cash. The commenter asserted that no meaningful distinction existed between loss corporation stock acquired by a Small Shareholder directly from the loss corporation in exchange for cash and loss corporation stock acquired as a result of the conversion of a debt instrument that was issued by the loss corporation in exchange for cash.

In general, the cash issuance exception is based upon an assumption that there is overlapping ownership between existing public shareholders and those shareholders who purchase additional stock of a loss corporation. In recognition of the fact that a loss corporation cannot establish this overlapping ownership in many cases, the cash issuance exception mitigates the owner shift that otherwise would result if the segregation rules were to apply in a manner that disregards the overlapping ownership that likely exists.

The IRS and the Treasury Department believe that the assumption of overlapping ownership does not necessarily extend to existing public shareholders and

purchasers of convertible debt or transferors of non-cash property for stock. Stated differently, persons who lend money to a loss corporation or persons who transfer non-cash property for stock in many cases may be different from public shareholders of the loss corporation. Furthermore, because infusions of capital into the loss corporation directly implicate the policies of section 382, the IRS and the Treasury Department believe that the cash issuance exception should retain its current scope. Accordingly, these final regulations do not adopt the commenter's proposal.

#### H. Coordinated Acquisition Rule

The preamble to the proposed regulations requested comments as to the scope of §1.382-3(a), which provides, in part, that a group of persons making a coordinated acquisition of stock can constitute an entity for purposes of section 382.

Comments were received requesting guidance that would identify specific situations in which stock purchases would not be treated as a coordinated acquisition. For example, one commenter asked for guidance to provide that a loss corporation may rely on the presence or absence of a filing with the Securities and Exchange Commission as a "group" to establish the presence or absence of a coordinated acquisition. After considering these comments, the IRS and the Treasury Department believe that further study of this issue is required, and that the development of a companion notice of proposed rulemaking to address this issue would significantly delay issuance of these final regulations. Accordingly, the coordinated acquisition rule is not addressed contemporaneously with these final regulations, but may be addressed in future guidance.

#### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. The certification is based on the fact that this rule would not impose new burdens on small entities and, in fact, may reduce the recordkeeping burden on small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking that preceded this final regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

#### **Drafting Information**

The principal author of these regulations is Stephen R. Cleary of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in their development.

#### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

#### **Adoptions of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.382-3 also issued under 26 U.S.C. 382(g)(4)(C) and 26 U.S.C. 382(m).

\* \* \*

Par. 2. Section 1.382-3 is amended as follows:

1. Revising paragraph (j) heading and paragraph (j)(1).
2. Revising paragraph (j)(11).
3. Redesignating paragraph (j)(13) and (14) as (j)(16) and (17).
4. Adding new paragraphs (j)(13) through (15).
5. Adding new Examples 5, 6, 7, 8, 9, 10, 11, 12, and 13 to newly redesignated paragraph (j)(16).
6. Revising newly redesignated paragraph (j)(17).

The revisions and additions read as follows:

§1.382-3 Definitions and rules relating to a 5-percent shareholder.

\* \* \* \* \*

(j) Modification of the segregation rules of §1.382-2T(j)(2)(iii) and (3)--(1)

Introduction. This paragraph (j) exempts, in whole or in part, certain transfers of stock from the segregation rules of §1.382-2T(j)(2)(iii) and (3). Terms and nomenclature used in this paragraph (j), and not otherwise defined herein, have the same meanings as in section 382 and the regulations issued under section 382.

\* \* \* \* \*

(11) Application to first tier and higher tier entities--(i) In general. The principles of paragraphs (j)(1) through (10) and paragraph (j)(12) apply to issuances of stock by a first tier entity or a higher tier entity that owns 5 percent or more of the loss corporation's stock (determined without regard to §1.382-2T(h)(2)(1)(A)).

(ii) Small issuance limitation. In applying paragraph (j)(2) of this section to any

issuance of stock by a first tier or higher tier entity, the small issuance limitations of paragraph (j)(2)(iii)(A) and (B) of this section are computed by reference to the stock value and the stock classes of the issuing corporation.

\* \* \* \* \*

(13) Secondary transfer exception. The segregation rules of §1.382-2T(j)(3)(i) will not apply to the transfer of a direct ownership interest in the loss corporation by a first tier entity or an individual that owns five percent or more of the loss corporation to public shareholders. Instead, each public group existing at the time of the transfer will be treated under §1.382-2T(j)(3)(i) as acquiring its proportionate share of the stock exempted from the application of §1.382-2T(j)(3)(i). The segregation rules also will not apply if an ownership interest in an entity that owns five percent or more of the loss corporation (determined without regard to the application of §1.382-2T(h)(2)(i)(A)) is transferred to a public owner or a 5-percent owner who is not a 5-percent shareholder of the loss corporation. Instead, provided that the transferor is either a 5-percent owner that is a 5-percent shareholder of the loss corporation or a higher tier entity owning five percent or more of the loss corporation (determined without regard to the application of section 1.382-2T(h)(2)(i)(A)), each public group of the entity existing at the time of the transfer is treated under §1.382-2T(j)(3)(i) as acquiring its proportionate share of the transferred ownership interest. With regard to a transferor that is neither a 5-percent shareholder of the loss corporation nor a higher tier entity owning five percent or more of the loss corporation (determined without regard to the application of §1.382-2T(h)(2)(i)(A)), see generally §1.382-2T(e)(1)(ii) (disregarding these transactions if the transferee is not a 5-percent shareholder).

(14) Small redemption exception--(i) In general. Section 1.382-2T(j)(2)(iii)(C) does not apply to a small redemption (as defined in paragraph (j)(14)(ii) of this section), except to the extent that the total amount of stock redeemed in that redemption and all other small redemptions previously made in the same taxable year (determined in each case on redemption) exceeds the small redemption limitation. This paragraph (j)(14) does not apply to a redemption of stock that, by itself, exceeds the small redemption limitation.

(ii) Small redemption defined. Small redemption means a redemption of public shareholders by the loss corporation of an amount of stock not exceeding the small redemption limitation.

(iii) Small redemption limitation--(A) In general. For each taxable year, the loss corporation may, at its option, apply this paragraph (j)(14)--

(1) On a corporation-wide basis, in which case the small redemption limitation is 10 percent of the total value of the loss corporation's stock outstanding at the beginning of the taxable year (excluding the value of stock described in section 1504(a)(4)); or

(2) On a class-by-class basis, in which case the small redemption limitation is 10 percent of the number of shares of the class redeemed that are outstanding at the beginning of the taxable year.

(B) Class of stock defined. For purposes of this paragraph (j)(14)(iii), a class of stock includes all stock with the same material terms.

(C) Adjustments for stock splits and similar transactions. Appropriate adjustments to the number of shares of a class outstanding at the beginning of a taxable year must be made to take into account any stock split, reverse stock split,

stock dividend to which section 305(a) applies, recapitalization, or similar transaction occurring during the taxable year.

(D) Exception. The loss corporation may not apply this paragraph (j)(14)(iii) on a class-by-class basis if, during the taxable year, more than one class of stock is redeemed in a single redemption (or in two or more redemptions that are treated as a single redemption under paragraph (j)(14)(v) of this section).

(E) Short taxable years. In the case of a taxable year that is less than 365 days, the small redemption limitation is reduced by multiplying it by a fraction, the numerator of which is the number of days in the taxable year, and the denominator of which is 365.

(iv) Proportionate redemption of exempted stock--(A) In general. Each direct public group that exists immediately before a redemption to which this paragraph (j)(14) applies is treated as having been redeemed of its proportionate share of the amount of stock exempted from the application of §1.382-2T(j)(2)(iii)(C) under this paragraph (j)(14).

(B) Actual knowledge of greater redemption. Under the last sentence of §1.382-2T(k)(2), the loss corporation may treat direct public groups existing immediately before a redemption to which this paragraph (j)(14) applies as having been redeemed of more stock than the amount determined under paragraph (j)(14)(iv)(A) of this section, but only if the loss corporation actually knows that the amount redeemed from those groups in the redemption exceeds the amount so determined.

(v) Certain related redemptions. For purposes of this paragraph (j)(14), two or more redemptions (including redemptions of stock by first tier or higher tier entities) are treated as a single redemption if--

(A) The redemptions occur at approximately the same time pursuant to the same plan or arrangement; or

(B) A principal purpose of redeeming the stock in separate redemptions rather than in a single redemption is to minimize or avoid an owner shift under the rules of this paragraph (j)(14).

(vi) Certain non-stock ownership interests. As the context may require, a non-stock ownership interest in an entity other than a corporation is treated as stock for purposes of this paragraph (j)(14).

(vii) Application to first tier and higher tier entities--(A) In general. The principles of this paragraph (j)(14) apply to redemptions of stock by a first tier entity or a higher tier entity that owns 5 percent of the loss corporation stock (determined without regard to §1.382-2T(h)(2)(i)(A)).

(B) Small redemption limitation. In applying this paragraph (j)(14) to any redemption of stock by a first tier or a higher tier entity, the small redemption limitations of paragraph (j)(14)(iii)(A) of this section are computed by reference to the stock value and the stock classes of the redeeming corporation.

(15) Exception for first tier and higher tier entities--(i) In general. The segregation rules of §1.382-2T(j)(3)(iii) will not apply to a transaction involving stock in a first tier or a higher tier entity if, after taking into account the results of such transaction and all other transactions occurring on that date, the first tier or higher tier entity owns 10 percent or less (by value) of all the outstanding stock (without regard to §1.382-2(a)(3)) of the loss corporation.

(ii) Anti-avoidance rule. The rules of paragraph (j)(15)(i) of this section do not



apply to a transaction involving an ownership interest in a first tier or higher tier entity if the loss corporation, directly or through one or more persons, has participated in planning or structuring the transaction with a view to avoiding the application of the segregation rules. For this purpose, a transaction includes any event that would result in segregation under §1.382-2T(j)(3)(iii), absent the application of this paragraph (j)(15), and any event (for example, the formation of a holding company) occurring as part of the same plan that includes the event that would result in segregation (without the application of this paragraph (j)(15)). Other anti-avoidance rules continue to be applicable. See, for example, §§1.382-2T(k)(4) and 1.382-3(a)(1).

(iii) Special rules. If application of paragraph (j)(15)(i) of this section results in the combination of public groups, then--

(A) The amount of increase in the percentage of stock ownership of the continuing public group will be the sum of its increase and a proportionate amount of any increase by any public group that is combined with the continuing public group (the former public group); and

(B) The continuing public group's lowest percentage ownership will be the sum of its lowest percentage ownership and a proportionate amount of the former public group's lowest percentage ownership.

(iv) Ownership of the loss corporation. In making the determination under paragraph (j)(15)(i) of this section--

(A) The rules of §1.382-2T(h)(2) will not apply;

(B) The entity will be treated as owning the loss corporation stock that it actually owns, and any other loss corporation stock if that other stock would be attributed to the

entity under section 318(a) (without regard to paragraph (4) thereof) unless an option is treated as exercised under §1.382-4(d)); and

(C) The operating rules of paragraph (j)(15)(v) of this section will apply.

(v) Operating rules. Subject to the principles of §1.382-2T(k)(4), a loss corporation may establish the ownership limitation of paragraph (j)(15)(i) of this section through either--

(A) Actual knowledge; or

(B) Absent actual knowledge to the contrary, the presumptions regarding stock ownership in §1.382-2T(k)(1).

(16) Examples. \* \* \*

Example 5. Secondary transfer exception to segregation rules – no new public group. (i) Facts. L is owned 60 percent by one public group (Public L<sub>1</sub>) and 40 percent by another public group (Public L<sub>2</sub>). On July 1, 2014, individual A acquires 10 percent of L's stock over a public stock exchange. On December 31, 2014, A sells all of his L stock over a public stock exchange. No individual or entity acquires as much as five percent of L's stock as a result of A's disposition of his L stock. On January 3, 2015, individual B acquires 10 percent of L's stock over a public stock exchange. On June 30, 2015, B sells all of her L stock over a public stock exchange. No individual or entity acquires as much as five percent of L's stock as a result of B's disposition of her L stock.

(ii) Analysis. The dispositions of the L stock by A and B are not transactions that cause the segregation of L's direct public groups that exist immediately before the transaction (Public L<sub>1</sub> and Public L<sub>2</sub>). When A and B sell their shares to public shareholders over the public stock exchange, the shares are treated as being reacquired by Public L<sub>1</sub> and Public L<sub>2</sub>. As a result, Public L<sub>1</sub>'s ownership interest is treated as increasing from 54 percent to 60 percent during the testing period, and Public L<sub>2</sub>'s ownership interest is treated as increasing from 36 percent to 40 percent during the testing period.

Example 6. Secondary transfer exception – first tier entity. (i) Facts. L has a single class of common stock outstanding that is owned 60 percent by a direct public group (Public L) and 40 percent by P. P is owned 20 percent by individual A and 80 percent by a direct public group (Public P). On October 6, 2014, A sells 50 percent of his interest in P to B, an individual who is, and remains, a member of Public P.

(ii) Analysis. P is an entity that owns five percent or more of L. A is a 5-percent owner of P that is a 5-percent shareholder of L. Because A's sale of the P stock is to a member of Public P, the disposition of the P stock by A is not a transaction that causes the segregation of P's direct public group that exists immediately before the transaction (Public P). See paragraph (j)(13) of this section. When A sells his shares to B, the shares are treated as being acquired by Public P. As a result, Public P's ownership interest in L is treated as increasing from 32 percent to 36 percent during the testing period.

Example 7. Small redemption exception. (i) Facts. L is a calendar year taxpayer. On January 1, 2014, L has 1,060 shares of a single class of common stock outstanding, all of which are owned by a single direct public group (Public L). On July 1, 2014, L acquires 60 shares of its stock for cash. On December 31, 2014, in an unrelated redemption, L acquires 90 more shares of its stock for cash. Following each redemption, L's stock is owned entirely by public shareholders. No other changes in the ownership of L's stock occur prior to December 31, 2014.

(ii) Analysis – (A) July redemption. The July redemption is a small redemption because the number of shares redeemed (60) does not exceed 106, the small redemption limitation (10 percent of the number of common shares outstanding on January 1, 2014). Under paragraph (j)(14) of this section, the segregation rules of §1.382-2T(j)(2)(iii)(C) do not apply to the July redemption. Under paragraph (j)(14)(iv) of this section, Public L is treated as having all 60 shares redeemed.

(B) December redemption. The December redemption is a small redemption because the number of shares redeemed (90) does not exceed 106, the small redemption limitation (10 percent of the number of common shares outstanding on January 1, 2014). However, under paragraph (j)(14)(i) of this section, only 46 of the 90 shares redeemed are exempted from the segregation rules of §1.382-2T(j)(2)(iii)(C) because the total number of shares of common stock redeemed in the July and December redemptions exceeds 106, the small redemption limitation, by 44. Accordingly, under paragraph (j)(14)(iv) of this section, Public L is treated as having 46 shares redeemed in the December redemption. Section 1.382-2T(j)(2)(iii)(C) applies to the remaining 44 shares redeemed. Accordingly, Public L is segregated into two different public groups immediately before the transaction (and thereafter) so that the redeemed interests (Public RL) are treated as part of a public group that is separate from the ownership interests that are not redeemed (Public CL). Therefore, as a result of the December redemption, Public CL's interest in L increases by 4.4 percentage points (from 95.6 percent (956/1,000) to 100 percent (910/910)) on the December 31, 2014 testing date. For purposes of determining whether an ownership change occurs on any subsequent testing date having a testing period that includes the December redemption, Public CL is treated as a 5-percent shareholder whose percentage ownership interests in L increased by 4.4 percentage points as a result of such redemption.

Example 8. Segregation rules inapplicable – proportionate amount. (i) Facts. P<sub>1</sub>

is a corporation that owns 8 percent of the stock of L. The remaining L stock (92 percent) is owned by Public L. P<sub>1</sub> is entirely owned by Public P<sub>1</sub>. P<sub>2</sub> is a corporation owned 90 percent by individual A and 10 percent by a public group (Public P<sub>2</sub>). On May 22, 2014, P<sub>1</sub> merges into P<sub>2</sub> with the shareholders of P<sub>1</sub> receiving an amount of P<sub>2</sub> stock equal to 25 percent of the value of P<sub>2</sub> immediately after the reorganization. L was owned 92 percent by Public L and 8 percent by P<sub>1</sub> throughout the testing period ending on the date of the merger.

(ii) Analysis. Assuming L can establish that P<sub>2</sub> owns 10 percent or less (by value) of L on May 22, 2014 pursuant to the operating rules of paragraph (j)(15)(v) of this section, the segregation rules of §1.382-2T(j)(3)(iii) will not apply to segregate P<sub>1</sub>'s direct public group (Public P<sub>1</sub>) immediately before the merger from P<sub>2</sub>'s direct public group (Public P<sub>2</sub>). Thus, following the merger, P<sub>2</sub> is owned 67.5 percent (90 percent x 75 percent) by A and 32.5 percent (25 percent + (10 percent x 75 percent)) by Public P<sub>2</sub>. Pursuant to paragraph (j)(15)(iii)(B) of this section, Public P<sub>2</sub>'s lowest percentage of ownership is the sum of its lowest percentage of ownership (zero) and a proportionate amount of former Public P<sub>1</sub>'s lowest ownership percentage of L of 2.6 percent (32.5 percent x 8 percent). P<sub>2</sub> will be treated as having one public group whose ownership interest in L was 2.6 percent before the merger and remains 2.6 percent after the merger. Because Public P<sub>2</sub> owns less than 5 percent of L, Public P<sub>2</sub> is treated as part of Public L. See §1.382-2T(j)(1)(iv). Thus, pursuant to paragraph (j)(15)(iii)(B) of this section, Public L's lowest ownership percentage of L during the testing period is 94.6 percent.

Example 9. Segregation rules inapplicable – prior increase in ownership by former public group during testing period. (i) Facts. The facts are the same as Example 8, except that P<sub>1</sub> acquired its 8 percent interest in L during the testing period that includes the merger.

(ii) Analysis. Pursuant to the rules of paragraph (j)(15)(iii)(A) of this section, the amount of increase in the percentage of stock ownership by Public P<sub>2</sub> is the sum of its increase (zero) and a proportionate amount of the increase by former Public P<sub>1</sub> of 2.6 percent (32.5 percent x 8 percent). Pursuant to paragraph (j)(15)(iii)(B) of this section, Public P<sub>2</sub>'s lowest percentage of ownership is zero, because both former Public P<sub>1</sub> and Public P<sub>2</sub> owned no L stock at the beginning of the testing period. Accordingly, Public P<sub>2</sub>, the continuing public group, is treated as having increased its ownership interest by 2.6 percent. Because Public P<sub>2</sub> is treated as part of Public L, Public L is treated as increasing its ownership interest by 2.6 percent.

Example 10. Ownership limitation based upon fair market value. (i) Facts. L has one class of common stock and one class of preferred stock outstanding. The preferred stock is stock within the meaning of §1.382-2(a)(3). Before December 23, 2014, a direct public group (Public L) owns all of the common stock of L. On December 23, 2014, P purchases all of the preferred stock of L and a portion of the common stock of L. On the date of purchase, the value of the L common stock held by P was greater than 5 percent of the value of L, and the total value of L common and L preferred stock

held by P was less than 10 percent of the value of all stock of L. P has one class of common stock outstanding, all of which is owned by a direct public group (Public P). On October 7, 2015, P redeems 30 percent of its single outstanding class of common stock. On the redemption date of the P stock, due to a decline in the relative value of the common stock of L, the preferred stock of L owned by P represents 40 percent of the value of all the outstanding stock of L. No ownership change of L occurs between December 23, 2014, and October 7, 2015.

(ii) Analysis. The rules of paragraph (j)(15) of this section do not apply to the redemption because P owns more than 10 percent of L (by value) on that date.

Example 11. Ownership limitation – fair market value includes preferred stock. The facts are the same as in Example 10, except that the preferred stock is not stock within the meaning of §1.382-2(a)(3). Although the preferred stock is not stock for the purpose of determining owner shifts, the value of that stock is taken into account in computing the 10-percent limitation of paragraph (j)(15)(i) of this section. Therefore, the results are the same as in Example 10.

Example 12. Ownership limitation – application of attribution rules. (i) Facts. Individual A owns all the outstanding stock of X. A also owns preferred stock in Y that is not stock within the meaning §1.382-2(a)(3), which represents 50 percent of the value of Y. All the Y common stock is owned by public owners. Each of X and Y own 6 percent of the single class of L stock outstanding. On October 6, 2014, Y redeems 15 percent of its common stock.

(ii) Analysis. In determining satisfaction of the ownership limitation of paragraph (j)(15)(i) of this section, the attribution rules of section 318(a) apply. Pursuant to section 318(a)(2), A is treated as owning the L stock owned by X. Pursuant to section 318(a)(3), Y is treated as owning the L stock that A indirectly owns. Because Y's ownership of L exceeds the 10 percent ownership limitation of paragraph (j)(15)(i) of this section, the rules of paragraph (j)(15) of this section do not apply.

Example 13. Anti-avoidance rule. (i) Facts. P<sub>1</sub> is a corporation that owns 10 percent of the stock of L. P<sub>1</sub> is owned entirely by a direct public group (Public P). L has had owner shifts of 45 percentage points in its current testing period. P<sub>1</sub> is planning to merge into P<sub>2</sub>, a corporation which has a public group. Advisers to L, upon learning of the proposed merger, asked the management of P<sub>1</sub> for details of the proposed merger, including the stock ownership of P<sub>2</sub> after P<sub>1</sub> merges into P<sub>2</sub>. After finding out that information, L or L's advisers did not request any changes in the planned transaction.

(ii) Analysis. The anti-avoidance rule of paragraph (j)(15)(ii) of this section does not apply because L did not participate in planning or structuring the transaction. Pursuant to paragraph (j)(15)(i) of this section, §1.382-2T(j)(3)(iii) does not apply to cause the segregation of P<sub>1</sub>'s public group from P<sub>2</sub>'s public group.

(17) Effective/applicability date. This paragraph (j) generally applies to issuances

or deemed issuances of stock in taxable years beginning on or after November 4, 1992. However, paragraphs (j)(11)(ii) and (j)(13) through (15) of this section and Examples 5 through 13 of paragraph (j)(16) of this section apply to testing dates occurring on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. Taxpayers may apply paragraphs (j)(11)(ii) and (j)(13) through (15) of this section and Examples 5 through 13 of paragraph (j)(16) of this section in their entirety to all testing dates that are included in a testing period beginning before and ending on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. However, the provisions described in the preceding sentence may not be applied to any date on or before the date of any ownership change that occurred before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]** under the regulations in effect before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, and they may not be applied as described in the preceding sentence if such application would result in an ownership change occurring on a date before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]** that did not occur under the regulations in effect before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. See §1.382-3(j)(14)(ii) and (iii), as contained in 26 CFR part 1 revised as of April 1, 1994, for the application of paragraph (j)(10) to stock issued on the exercise of certain options exercised on or after November 4, 1992 and for an election to apply paragraphs (j)(1) through (12) retroactively to certain issuances and deemed issuances of stock occurring in taxable years prior to November 4, 1992.

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Deputy Commissioner for Operations Support

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